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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1933

Nos. 727 and 728

SPRING CITY FOUNDRY COMPANY,
PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

PETITION FOR REHEARING

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To the Honorable THE SUPREME COURT OF THE UNITED STATES:

Comes now the petitioner in the above entitled causes and presents this, its petition for a rehearing of said causes, and in support thereof respectfully shows:

I.

The decision, as announced April 30, 1934, that the taxpayer was required to report the receivable in question as gross income in 1920, omits to give the legal effect to Section 234(a)(5) previously held by the court; that is, that the taxpayer is authorized, when proceeding in good faith, upon proper investigation, to make the determination that the account is ascertained to be worthless.

The court in its opinion has said:

> "We are of the opinion that sec. 234 (a) (5) of the Act of 1918 authorized only the deduction of a debt ascertained to be worthless and charged off within the taxable year; that it did not authorize the deduction of a debt which was not then ascertained to be worthless or was recoverable in part, the amount that was not recoverable being still uncertain. Here, in 1923, on the winding up, the debt that then remained unpaid, after deducting the dividends received, was ascertained to be worthless and the commissioner allowed deduction accordingly in that year." 54 Sup. Ct. Rep. 644, 647.

We now raise the question whether it may properly be said that the debt *"was ascertained to be worthless" in 1923.*

We think it was ascertained to be worthless in 1920, and that the taxpayer justifiably charged off the item in that year; that the taxpayer's determination of worthlessness after bankruptcy was conclusive, being made in good faith and after due investigation.

Article 141 of the Treasury Regulations 45 provides that losses incurred in the taxpayer's trade or business, or in any transaction entered into for profit may be deducted but such losses "must usually be evidenced by closed and completed transactions."

Article 151 of Treasury Regulations 45 provides in part:

> "Where all the surrounding and attendant circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for the purpose of deduction."

The bankruptcy of the taxpayer's debtor, which occurred in 1920, and the appointment of a receiver by the bankruptcy court, effectually disabled the taxpayer from resorting to "legal action to enforce payment" and suspended all right to "execution upon the judgment." These facts suffice, in the language of the regulations, as "evidence of the worthlessness of the debt for the purpose of deduction."

Effect must be given to the significant words of the regulation that *"for the purpose of deduction"* a showing of the facts stated in the regulation "will be sufficient evidence of the worthlessness of the debt." This clearly indicates that it was not contemplated by the Commissioner of Internal Revenue that absolute and ultimate worthlessness by complete and final liquidation was required to justify the belief of the taxpayer that it was a closed transaction for the purpose of deduction of the debt as worthless.

Of this case, as in *United States v. White Dental Manufacturing Company,* 274 U. S. 398, 401, it could be said:

> "The case turns upon the question whether the loss, concededly sustained by the respondent through the seizure of the assets of the German Company in 1918, was so evidenced by a closed transaction within the meaning of the quoted statute and treasury regulations as to authorize its deduction from gross income of that year."
>
> The statute and regulations "do contemplate the deduction from gross income of losses, which are fixed by identifiable events, such as the sale of property (Arts. 141, 144), or caused by its destruction or physical injury (Arts. 141-143), *or, in the case of debts, by the occurrence of such events as prevent their collection* (*Art.* 151)". p. 401.

> "That legal action by respondent upon its open accounts against a corporation thus despoiled would have been fruitless within the meaning of Article 151 seems not open to question." p. 402

The *White Dental* case, just as the case at bar, involved a worthless debt under the 1918 Act. To quote further from that case:

> "The quoted regulations, consistently with the statute, contemplate that a loss may become complete enough for deduction without the taxpayer's establishing that there is no possibility of an eventual recoupment." p. 402

The foregoing legal proposition is exactly what the taxpayer contends for in this case, while the decision here would seem in effect to require, as a condition precedent to the deduction of the taxpayer's loss, that all "possibility of an eventual recoupment" must be extinguished before the transaction *became closed* so as to give rise to a deductible loss within the meaning of the 1918 statute.

In concluding the opinion in the case of *United States v. White Dental Manufacturing Company* the court said:

> "We need not attempt to say what constitutes a closed transaction evidencing loss in other situations. It is enough to justify the deduction here that the transaction causing the loss was completed when the seizure was made. It was none the less a deductible loss then, although later the German government bound itself to repay and an award was made by the Mixed Claims Commission which may result in a recovery", p. 403.

It should be noted that apart from the 1924 award of the Mixed Claims Commission, which might or might not result eventually in a recovery, *there had already been a recovery of* $6,000.00 *of the charged-off loss which*

was returned as income by the taxpayer in 1922. In fact, except for the character of the transaction involved in the two cases, the one being a seizure of the debtor's assets by the German government during the war, and the other being a seizure of the debtor's assets by governmental authority in federal bankruptcy proceedings, it would seem that the facts and the applicable principles of law in the two cases are identical and that the result here is inconsistent with the principles announced in the case cited.

That the taxpayer proceeded in good faith and upon due investigation in his determination of the worthlessness of the account in toto in 1920, is made clearly to appear by the opinion of the Circuit Court of Appeals in this case where it is said:

> "Was the account worthless? We could justifiably answer this question by observing that the evidence was such as to warrant the negative answer which the Commissioner and the Board of Tax Appeals gave to it. *And it might be added that there was evidence sufficient to sustain an affirmative answer.*" (Italics ours) (R. 108)

This finding may have been influenced by the fact that the Jos. T. Ryerson & Sons Company and the LaSalle Steel Company, of Chicago, likewise charged off, in 1920, their entire claims against this debtor as wholly worthless, and the house attorney of the Ryerson Company never heard of any objection by the federal taxing authorities to such deduction. (R. 38, 40).

If the evidence was sufficient to have warranted the Commissioner and the Board of Tax Appeals in finding, had they so found, that the account was wholly worthless in 1920, must it not necessarily follow that the taxpayer *justifiably ascertained* the account to be worthless and

rightly wholly charged it off as an asset in 1920, and that the taxpayer was fully warranted by the facts, of which he had knowledge in 1920, in considering the *transaction closed within the meaning of the statute* and the treasury regulations, so as to authorize the deduction of the entire account from gross income of that year, and that such determination should prevail over the post mortem determination "and ascertainment of worthlessness" made by the Commissioner in *1925* in allowing a deduction in the taxable year 1923 for the portion of the debt which had in that year become established as beyond the possibility of further recoupment.

> "Presumptively the taxpayer's decision that a debt is worthless, and so charged off, measures his loss."
>
> *Sherman & Bryan, Inc. v. Commissioner,* (C. C. A.-2), 35 F. (2d) 713, 717.
>
> See also *Selden v. Heiner,* 12 F. (2d) 474, 477-8.

It has been said by this court that "the taxing act does not require the taxpayer to be an incorrigible optimist". *U. S. v. White Dental Mfg. Co.,* 274 U. S. 398, 403. The taxpayer here may have nursed the hope of eventual partial recoupment from a liquidating dividend in bankruptcy, but in 1920 that was a remote and uncertain contingency. The economic recovery in 1921 and 1922 resulted in realizing for this worthless debt something which it was not worth at the close of 1920. The court will take judicial notice of the fact that there was a marked economic recession in the latter part of 1920 and a decided recovery which began in 1921, rising very rapidly to a minor climax in 1923 and reaching a final climax in 1929. The bankruptcy trustee himself testified that the dividends to creditors were made possible by

reason of the change in general business conditions; that the price that he got for the debtor's property, in his opinion, was brought about by such change. (R. 35) But the taxpayer in 1920 could not foresee this recovery and the consequent realization of part of its claim in bankruptcy. Its determination, its ascertainment, in 1920, of the total worthlessness of the debt should be recognized and approved, and, hence, being worthless in law for taxing purposes under the statute and the appropriate regulations, the taxpayer was not required to return it as income either in whole or in part in the year 1920. In this we rely upon the authority of the *U. S. v. White Dental Mfg. Co.* case, 274 U. S. 398, as we understand the decision.

We submit that the decision of the court below ought to be reversed upon this ground.

II.

The court's interpretation of Section 234(a)(5) of the Revenue Act of 1918 is not applicable to the situation of this taxpayer under the facts as found by the lower courts in this case.

By the decision of the Board of Tax Appeals, the affirmance of the Circuit Court of Appeals and the refusal of this court to grant a writ of certiorari upon the issue (which is in effect an affirmance in this case), the fact has been established by conclusive judicial decision that the account was worthless in 1920 to the extent of $28,715.76. The taxpayer has disclaimed such a divine power of foresight but it is nevertheless conclusively bound by this judicial determination. It is res judicata, or, more appropriately, res judicata facit ex albo nigrum, ex nigro album, ex curvo rectum, ex recto curvum.

We thus have a taxpayer who, by judicial decision, in 1920 has a receivable worth $11,267.51 and worthless to the extent of $28,715.76. Under our theory of jurisprudence this is a *truth*, a *verity*. It is still a verity in 1923. Being held to these values in 1920, what is there in 1923 that permits the deduction in 1923 and not in 1920? There seems to be no logical basis under the court's decision for allowing the Commissioner to require the deduction of the $28,715.76 in 1923 instead of 1920. It is still a debt partially worthless to the extent of $28,715.76. Under the decision of the court as applied to this case a partially worthless debt could never be deducted. The condition has not changed in 1923. It just happens that the accrued value of $11,267.51 was received in cash in 1923, but that has nothing whatever to do with the ascertainment of the value of the account in 1920, nor with the proper method of treating the same under the accrual basis to which this taxpayer is held committed. The Commissioner would thus hold the taxpayer to the accrual basis of reporting by compelling it to include in 1920 taxable income the entire account of $39,983.27, even though it was then worthless to the extent of $28,715.76, and not allow the deduction to be made in 1920 because the $11,267.51 value was not actually received in cash until 1923. The Commissioner cannot blow both hot and cold on the same proposition and say on the one hand that this taxpayer is on the accrual basis and therefore must recognize in 1920 the then actual value but cannot give effect to that knowledge until 1923 because it did not collect in full on the accrual until 1923. The result of this is to require the taxpayer to recognize the accrual basis for one purpose in 1920 and yet to report upon the cash basis in 1923

in order that a tax of $13,209.25 plus interest may be collected upon a fictitious item of $28,715.76.

Under the doctrine of res adjudicata as applied to the decision of the Board of Tax Appeals there is nothing uncertain about the value of the account in 1920. Under the holding of the court partial recognition is given to this conclusive finding, that is, to the extent of forbidding the use of taxpayer's determination of complete worthlessness, but full recognition is denied until this conclusive finding is made doubly conclusive by receipt of the amount in cash in 1923.

The decision of the court thus approves a practice on the part of the Commissioner of reconstructing taxpayer's transactions five years after the event (1925) as of the date of the event (1920) but in the light of post facto occurrences during that period. The Commissioner, acting in the light of changed conditions, is allowed "to project his prophecy backwards", while the taxpayer, though exercising an honest discretion in the light of facts diligently ascertained, is held to an infallible vision of post revelation.

This court has indicated that this account was *ascertained* to be worthless only after recovery had been received in cash in 1923. This position rejects the Board's finding of 1920 worthlessness, now res adjudicata, relies solely upon the cash basis of accounting and gives no effect to the accrual basis to which the taxpayer was bound.

It is accordingly submitted that even though a partially worthless debt may not be deducted under the 1918 Act, nevertheless we here have a judicial ascertainment that this account was worthless in 1920 to the extent

of $28,715.76. Under the doctrine of res adjudicata there was nothing then uncertain about the account. The $28,715.76 so determined was wholly worthless, was so ascertained and should be allowed as a deduction in 1920. This is the same thing that the court allows to be done in 1923 and for the reasons above stated should be allowed in 1920.

We submit that the necessity for a consistent, workable rule of administration, recognition of the fundamental principle of res adjudicata, and justice, even life, to this taxpayer requires reversal of the decision of the court below.

WHEREFORE upon the foregoing grounds it is respectfully urged that this petition for a rehearing be granted and that the judgment of the Circuit Court of Appeals of the Seventh Circuit be upon further consideration reversed.

Respectfully submitted,

EDGAR L. WOOD
RICHARD H. TYRRELL
Counsel for Petitioner.

I, one of the counsel for the above named Spring City Foundry Company, do hereby certify that the foregoing petition for a rehearing of these causes is presented in good faith and not for delay.

EDGAR L. WOOD
Counsel for Petitioner.